

APPENDIX

NOTES FOR FOMC MEETING
August 22, 1989

Sam Y. Cross

During the latest intermeeting period, exchange markets have been somewhat calmer than before, with much less pressure on the dollar, and intervention operations have been at only a fraction of the level of May and June, in fact less than one-tenth. In July the dollar eased at times, then in August it moved back up, reflecting a shift in the market's assessment of the outlook for the U.S. economy and dollar interest rates. During recent weeks in particular, the dollar has shown impressive resilience, giving up ground only grudgingly on unfavorable news and moving up firmly with good news--such as last Thursday's trade figures. The dollar is now trading 3 to 4 percent higher than when the Committee last met seven weeks ago, but has traded consistently below the highs it traded in the previous period.

The dollar's decline during July took place on two occasions, and both times the dollar recovered quickly. The first decline occurred around the time of your last meeting, when the dollar was weighed down by the cumulative effect of heavy central bank intervention during May and June, and there was a tapering off of investor demand for dollars related to reducing hedges on dollar portfolios. With interest rates in the United States tending to ease at a time when other countries were raising rates to combat inflationary pressures, interest rate differentials favorable to the dollar were narrowing.

The second decline in dollar exchange rates took place in late July. Market participants were of the view that economic growth and price pressures in the United States had slackened. Debate was focused on the extent of the slowdown, and the question of how quickly would the Federal Reserve move to ease credit. In that environment, market participants scrutinized Federal Reserve money market operations, as well as Chairman Greenspan's comments in Congressional testimony, and the dollar declined somewhat as the market concluded that an easing in the underlying stance of the Federal Reserve was well under way and would continue. On August 2, the dollar reached its period lows of around DM 1.84 1/2 against the mark and ¥ 135 1/2 against the yen.

However, these two declines in the dollar were rather modest in amount and were not sustained. The initial sell-off of dollars by dealers and speculators was not reinforced with large dollar sales by corporate customers and investors. In part, the dollar's recovery was aided by geopolitical factors--the uncertainty surrounding the political situation in Japan, as well as uncertainties related to the Middle East and Eastern Europe. But also, the dollar's rebound to an important degree came when new economic data forced a rethinking of the outlook for dollar interest rates. The exchange market, perhaps like other markets, seemed to have gotten ahead of itself in late July in its expectations of economic slowdown and low interest rates. Thus the dollar rallied in early August, and the immediate catalyst behind the rally was a batch of statistics--dealing with

employment, prices, and retail sales--that lent credibility to the scenario that there would be a "soft landing" rather than a recession, prompting the market to conclude that further Fed easing was not so certain, at least for the near future. As institutions and corporates reentered the market to bid for dollars, the currency recovered fully from its loss of early August and moved higher, reaching period highs of DM 1.97 and Y 144 just after the release of the trade numbers last week.

Throughout this inter-meeting period the dollar has traded below the highs reached earlier in the year. But there were several occasions when upward pressures were significant. On those occasions, we and others intervened, to temper the dollar's rise and help keep it from gaining momentum, and to signal concern about the economic risks of a higher dollar and its implications for international adjustment. During the time when the demand for dollars was associated with uncertainty surrounding the Japanese elections, more of the intervention operations were against yen. Recent pressures have been more evenly balanced, and there have been dollar sales against both marks and yen. For the period as a whole the Desk's operations totaled sales of \$550 million against Japanese yen and \$400 million against German marks, one-half of which was on behalf of the Federal Reserve and one-half for the Treasury.

The dollar's recent movements suggest a clear bias toward a strong dollar, which seems able to absorb bearish news and rebound when that news has been digested by the market. The

dollar's strength stems, in part, from a market perception of relative political and economic stability in the United States. There is less attention on the budget deficit, and the balance of payments deficit seems to cause little market concern when, as at present, it is easily being financed by capital inflows. From a longer-term perspective, many investors still seem to regard the dollar as a good value at these levels.

Mr. Chairman, I would like to ask the Committee's approval for the Federal Reserve's share of the Desk's operations during the period, that is, for \$275 million of dollar sales against yen and \$200 million against marks. I would also like to advise you that the U.S. Treasury has warehoused an additional \$1 billion worth of marks with the Federal Reserve and that the Treasury has now warehoused \$4 billion of the \$5 billion currently authorized.

FOMC NOTES FOR
PETER D. STERNLIGHT
AUGUST 22, 1989

The Domestic Desk implemented two small easing steps in the period since the last meeting of the Committee in early July. Both were associated with reductions of \$50 million in the path allowance for seasonal and adjustment borrowing. The first move, however, undertaken immediately after the July 5-6 meeting, was accompanied by an upward technical adjustment of borrowing to allow for the higher seasonal borrowing that had developed in the weeks prior to that meeting; thus the change in path borrowing introduced in early July was actually an increase of \$100 million to \$600 million. It was nevertheless, as planned, accompanied by a reduction in the expected range of Federal funds trading from $9\frac{1}{2}$ - $5\frac{5}{8}$ to $9\frac{1}{4}$ - $3\frac{3}{8}$ percent. Toward the end of July a further easing move was implemented in light of incoming evidence suggesting greater moderation in the economy's pace and abatement of inflationary pressures. The reduction in the borrowing allowance to \$550 million was expected to be associated with funds trading largely in a 9 - $9\frac{1}{8}$ percent range.

Funds behaved about as expected, softening from $9\frac{1}{2}$ percent or a little over in the first few days of July to around $9\frac{1}{4}$ percent in the next two weeks. Partly in anticipation of further System accommodation the rate edged off to about $9\frac{1}{8}$ percent in the July 26 week, and then to around 9 or a shade under in the maintenance period ended August 9. In the current period, which ends tomorrow, the rate has averaged just about 9 percent so far, with trading on some days persisting slightly below 9 even though market expectations of imminent further easing steps have largely dried up.

Borrowing averaged slightly under the \$600 million path level in the maintenance periods ended July 12 and 26, but edged up to \$621 million in the August 9 period just as the path allowance was pared to \$550 million. The rise was caused by a reserve miss on the final day of that period, leading to a moderate bulge in window usage. So far in the current period, borrowing has averaged about \$540 million (through last Sunday).

For the most part, Domestic Desk operations were directed at absorbing reserves over the period, in large part neutralizing the reserve additions provided in the latest and preceding periods as a result of foreign exchange intervention. Declining Treasury balances in early July enlarged the need to absorb reserves. All told, outright holdings in the System Account were reduced by about \$9.1 billion, including a record-size market sale of \$4.6 billion of bills, sales of bills and notes to foreign accounts totaling about \$1.8 billion, and run-offs of \$2.6 billion of maturing bills in several auctions. On most days, the Desk was also in the market arranging temporary reserve absorptions through matched sale-purchase transactions. Bucking the trend on one day--the end of the July 12 maintenance period--the Desk provided a sizable block of reserves through overnight repurchase agreements, largely to cope with the effects of last-minute upward revisions to required reserves.

Upward revisions to required reserves were in fact fairly common over the intermeeting period, as might be expected along with the stronger performance of the monetary aggregates. All three money measures rose rapidly in July, lifting M2 and M3 to levels just equal to or slightly above the lower bounds of their cones. Reports for early August suggest further gains for M2 and M3 above their lower bounds for this month. M1 grew substantially in July

but was still below its level at the start of the year and early August data suggest at best a flat performance this month.

Against the background of a modestly declining funds rate, market yields underwent considerable gyrations during the period, as participants reacted to System moves, real or imagined, and a variety of reports on the economy. Yields on many instruments were somewhat higher at the end of the period than at the start, as many participants had already come to expect an extended series of easing steps. The System's easing move in early July, for example, was widely expected. Once that move was observed fresh anticipations of further moves were set up, particularly as business news remained on the soft side; by mid-July a number of market participants looked forward to appreciably lower funds rates--say, several more quarter point moves--as the summer and fall progressed. At the same time many analysts moved up their odds on the likelihood of a recession beginning very near term.

The Chairman's Humphrey-Hawkins testimony, with its acknowledgement of slower growth in the economy and confirmation of easing steps already undertaken, was regarded by some as providing further encouragement to the slow economy-easier policy view. Others, though, were equally or more impressed with the Fed's determination to accept an extended period of slow growth to damp inflation and felt further easing moves would be only very gradual. A particularly sobering note the day of the first testimony was the large money supply increase reported that afternoon, as it was tied back to the Chairman's statement that slow money growth had been a factor contributing to the earlier decision to ease.

Markets backed and filled over the last half of July and into early August, as encouragement was drawn from soft business reports while there was

also a consciousness of the Fed's probable desire to move slowly. The System's further easing step in late July was digested fairly calmly as "another step"--but not necessarily a harbinger of a long series of easing moves. In early August the mood became distinctly more sober as the July employment report showed a sizable upward revision for June nonfarm payrolls and a slight decline in the unemployment rate. Additional sobering news was received toward mid-August when July retail sales were reported up strongly along with upward revisions for earlier months. This did not sound at all like recession and many forecasts were revised accordingly. The lower trade deficit reported just a few days ago was initially greeted warmly in the bond market, but then the implications of the export component for a stronger economy were perceived and the market backed away.

Adding to the market's burden as it sought to evaluate new information on the economy and weigh policy prospects, the Treasury was shaping up its quarterly refunding in early August--with the further complications of a pending debt limit increase without which the refunding could not proceed, and the uncertainties of how the financing for the thrift bailout would finally emerge. Little wonder, then, that some rates ended the period higher than they started despite the moderately lower funds rate!

At the short end, bill rates ended with small mixed changes as compared with the rates just before the Committee's July meeting. Three- and six-month bills were auctioned yesterday at average rates of 7.99 and 7.85 percent, respectively, compared with 7.96 and 7.63 percent on July 3. Part-way through the period, when confidence in a succession of easing moves was riding high, three-month bills traded as low as 7.58 percent. To some extent the back-up in bills reflected supply considerations as the Treasury raised some \$12

billion in the bill market while the Federal Reserve lightened its own portfolio, as I noted earlier. These supply considerations did not prevail in the market for private short-term debt, and on instruments such as CDs and commercial paper there were net yield declines of roughly 15 to 45 basis points over the period. With bank funding costs down, banks acted to lower their prime lending rate 1/2 percent to 10 1/2 percent--a few moving in early July but most waiting until late in the month when the System made its further easing move.

Intermediate term Treasury issues, maturing in two to five years, showed some of the larger net increases over the period, about 25-35 basis points. At the longer end, the net rise was a more modest 15 to 20 basis points. The Treasury raised about \$17 billion through coupon issues during the period, the bulk of it in the August refunding. In that operation, taking place as yields were adjusting upward, underwriters did not fare well. Demand was modest for the 3- and 10-year issues and then improved for the 30-year bonds but even that issue struggled to hold near issue price in subsequent trading. The bonds were sold at an average yield of 8.14 percent and later traded in a range of 8.10 to 8.20 percent, which is where they are this morning. Earlier in the period, 30-year bonds had traded as low as about 7 3/4 percent. This morning's yields on the 3- and 10-year issues were, respectively, 30 and 20 basis points above their auction averages.

Mention should also be made of mortgage-backed instruments which have attracted attention as thrifts have been liquidating some of their holdings in the course of resolving insolvencies or moving toward compliance with tougher capital standards. While there has been considerable selling reported, it appears to have been well absorbed, initially by dealers and then often after

repackaging, by banks and other investors attracted to the moderately wider spreads over Treasuries that had developed by mid-year; those spreads actually worked down a bit in the intermeeting period.

I would describe the current market mood as one of subdued and edgy optimism. Few participants now look for imminent recession, while most fall in the modest growth camp for the next few quarters. Significantly, the strengthening of expectations about the economy did not seem to be accompanied by worsening inflationary fears, perhaps thanks partly to the continuing strong dollar and lower prices from energy and some other commodities. On policy expectations, most would look for no immediate change and some would extend that holding pattern indefinitely but many others still anticipate a further modest step or two on the easing side, some distance down the road.

Michael J. Prell
August 22, 1989

FOMC Briefing -- Economic Outlook

As you know, we've made some modifications to our economic forecast since last month's meeting. But before getting to those, I think I should emphasize that, in the broadest terms, the story has remained essentially the same.

That is, we still are portraying an economy undergoing a period of subpar growth as the Federal Reserve seeks to reduce inflationary pressures. Restraint on aggregate demand comes mainly from three sources: first, the monetary policy of the past couple of years which, despite our recent easing steps, has held real interest rates at relatively high levels; second, the firmness of the dollar on exchange markets since early 1988, which appears to be only partially attributable to monetary policy; and third, a moderately restrictive fiscal policy.

With that said, let me turn to the news of the past seven weeks. We, too, have been surprised by the strength of recent economic indicators, although we evidently placed a lower probability on recession than some private analysts and had not built into our forecast a significant decline in the federal funds rate -- let alone the plunge the market came to anticipate.

At this point, our forecast may still rest on assumptions that differ a bit from the prevailing market view, which appears to be that at least a modest easing of money market conditions remains ahead. While a further small decline in short rates wouldn't represent a major departure from what we've anticipated, our view basically is that, even

without such an easing, the economy will be strong enough in the near term to forestall progress toward restoration of a disinflationary trend. Although we have allowed for the possibility that a stable funds rate could be associated with a further back-up in longer-term yields, we are now projecting that real GNP will expand about 2 percent over the next four quarters, as compared with less than 1-1/2 percent in the last Greenbook. And, as a result, the jobless rate, rather than approaching 6 percent in mid-1990, is anticipated to be more like 5-1/2 percent.

The July labor market report provided limited support for this upward revision of near-term growth. I say "limited" because employment tends to be a coincident rather than a leading indicator. But the July report, along with the low level of initial claims for unemployment insurance into early August, suggests that jobs thus far have remained plentiful and that real disposable income probably has been rising at a good clip; under these circumstances, with consumer sentiment apparently improved of late, non-auto retail sales should remain on the more positive track revealed by the revised data of the past few months.

The rebound in the housing market has been in line with our expectations. If starts merely hold around the improved July level in the next few months, we should see appreciable growth in real residential investment outlays over the second half of this year.

Business capital spending also appears likely to rise considerably in the near term, albeit less rapidly than in the first half. Recent indications have been mixed, but, on the whole, the order books of U.S. manufacturers suggest that we should see further increases in shipments of equipment in coming months. I should note, however,

that some of that equipment will be showing up in exports rather than in domestic investment; this is particularly so in the case of commercial aircraft, and we alluded in the Greenbook to the expected spurt in Boeing deliveries to foreign customers later this year.

Those aircraft deliveries will come out of a production pipeline, where to date they presumably have been recorded as inventories. This consideration reinforces our impression that, potential auto problems aside, there is no serious overhang of stocks lurking out there; indeed, looking at the pattern of inventory data and manufacturing output, it appears that we may have largely completed a downward adjustment in materials stocks that was a drag on industrial production in the first half of this year.

All told, then, domestic private demand looks quite buoyant at this point, and the fact that we have projected only moderate GNP growth in the next few quarters is mainly attributable to two factors. The first is the weakness in federal spending, particularly defense procurement. And the second is our assessment that the contribution of net exports to GNP growth is likely to turn slightly negative for a time, pending a reversal of this year's appreciation of the dollar. Ted will be saying more about this in a moment.

As has been said so many times, a declining exchange rate is something of a two-edged sword. The rise in the dollar since last fall has been reflected in weak import prices, and has helped damp domestic inflation. If the dollar turns down as we have projected, then we can expect some price pressures on that front.

However, on net, we think that recent data warrant taking a more optimistic view of inflation prospects than we had earlier. While we believe that the somewhat smaller than expected increase in prices outside of food and energy thus far this year owes much to the appreciation of the dollar, we also have been impressed by the stability of wage inflation over the past year. Given the degree of labor market tightness, we would have expected a pickup. In our forecast, we do have compensation increases growing a little by year-end in some catchup with the rise in the cost of living that has occurred, but that acceleration is mild. The major inflationary damage coming along on the labor cost side is the jump in social security taxes in January. Experience suggests that the tax hike will not be much offset in other components of compensation and that this added cost will be passed through to prices quite fully within a few quarters. A minimum wage increase, if enacted, will add a touch more to these pressures.

The basic story, then, as we see it, is that a combination of legislated increases in labor costs and an upturn in import prices will result in a slight further pickup in inflation outside of food and energy next year -- in the face of rising unemployment and declining industrial capacity utilization. As I suggested earlier, we don't foresee meaningful reduction in core inflation before 1991. But, if that is the bad news, the relatively good news is that recent developments suggest that the level of inflation from which that reduction will begin may be lower than we previously projected. For example, the CPI ex. food and energy is now forecast to increase just under 5 percent next year -- only a shade lower than last month, but

more than half a percent below our prediction just two Greenbooks ago. And our forecast for the overall CPI in 1990, at 4-1/2 percent, is at the low end of the FOMC central-tendency range reported to the Congress last month.

I'd like now to turn the floor over to Ted.

E.M.Truman
August 22, 1989

FOMC Presentation -- International Developments

Since the last FOMC meeting, data on U.S. merchandise trade in May and June have been released. The two months together produced a smaller trade deficit in the second quarter than we anticipated at the time of the last FOMC meeting, with most of the change because of lower nonpetroleum imports. However, the June data that were released last Thursday after the Greenbook went to press were in line with our expectations embedded in the current Greenbook forecast.

For the second quarter as a whole, imports of petroleum and products rose substantially in both price and quantity, while nonpetroleum imports were essentially unchanged from first-quarter levels. Imports of automotive products declined for the second quarter in a row; imports of industrial supplies were flat, consistent with the adjustment of materials stocks that Mike has described; the only categories of nonpetroleum imports recording increases in the second quarter were capital goods and consumer goods.

On the export side, agricultural shipments were flat in the second quarter after a sharp increase in the first quarter. Nonagricultural exports posted further substantial increases in both value and quantity spread across industrial supplies, capital goods and consumer goods.

The overall trade balance in the second quarter was essentially unchanged from the \$110 billion at an annual rate published for the first quarter. Looking ahead, we are forecasting no further improvement in the trade balance over the next six quarters. In fact, we have a deterioration of about \$15 billion by the middle of 1990 and no change in the second half of that year. Although petroleum imports level off, non-petroleum imports are projected to resume their expansion under the influence of the strength of the dollar so far this year and somewhat more rapid U.S. economic activity now forecast for the second half of 1989. Meanwhile agricultural exports are projected to edge off, and the expansion of non-agricultural exports should be slowed by the strong dollar, despite an expected surge in shipments of aircraft in the second half of this year.

By the middle of 1990, the projected moderate real depreciation of the dollar and slower growth of the U.S. economy -- both absolutely and relative to growth abroad -- should arrest the deterioration of the trade balance and provide some support to real GNP. However, the nominal current account balance is projected to continue to deteriorate because of the rising cost of servicing our growing net liability position. Excluding capital gains and losses, it is projected to deteriorate from \$108 billion at an annual rate in the first quarter of this year to almost \$135 billion in the fourth quarter of 1990.

This widening of the current account deficit is one of the factors contributing to our projection of a resumption of the

depreciation of the dollar -- albeit at a rather moderate annual rate of about 7 percent in nominal terms (5-3/4 percent in real terms) over the forecast period. The other factor is a projected further small rise in interest rates in Germany and Japan relative to dollar interest rates.

The foreign exchange value of the dollar remains something of a wild card in our forecast, affecting, as Mike has noted, our outlook for prices as well as our outlook for the real economy and the process of external adjustment. It is useful to try to place both the dollar's projected depreciation over the forecast period and its actual rise over the first half of this year in perspective. Looking ahead with the help of the staff's econometric models, and assuming that M2 would grow at the rate incorporated in the staff forecast, an unchanged foreign exchange value of the dollar from its average level in the second quarter of this year has a negligible impact on 1989, but it would chip about 1/4 of a percentage point off of the growth of real GNP in 1990 and subtract a bit more from consumer price inflation. The current account deficit at the end of 1990 would be only a few billion dollars larger. However, in 1991 the effects of the stronger dollar would be larger -- on the order of 1/2 percent lower growth, 3/4 percent less inflation, and a current account deficit that would be about \$15 billion larger.

Looking back to our projection for the dollar at the time of the February chart show, which was for a decline in nominal terms of about 5 percent this year and 8 percent during 1990, one can also estimate the effects of the strong dollar so

far this year. (On balance, the dollar is now projected to be 11 percent stronger at the end of 1990.) Assuming a path for M2 unchanged from its actual and now projected path, the stronger dollar is estimated to be knocking almost 1/2 a percentage point off of the growth rate of real GNP this year and subtracting somewhat more than 1/2 a percentage point from consumer price inflation. As far as 1990 is concerned, the higher current path for the dollar would be associated with a touch more growth because interest rates do not need to rise as much to restrain the growth of M2, and inflation would be about 1/2 percent lower. Finally, the current account balance would be about \$15 billion larger at an annual rate by the fourth quarter of 1990.

Mr. Chairman, that completes our report.

August 22, 1989

FOMC -- Briefing
Donald L. Kohn

In domestic financial markets, the period since the last meeting has been marked by substantial swings in interest rates and rapid money growth. The interest rate movements were related importantly to shifting expectations of the likelihood of a further easing of monetary policy by the Federal Reserve. Right now, as Mike noted, some additional easing still appears to be built into the structure of short-term rates, but it is slight, and at least over the near term seems to incorporate a funds rate well above levels the market was looking for just a few weeks ago.

The market's reconsideration of the prospects for short-term rates likely was based both on stronger economic data and on readings of Federal Reserve objectives and intentions from our behavior in the open market. Differentiating between these types of influences may be useful in distinguishing whether the market perceives the Federal Reserve to have been effectively countering any incipient tendency for the economy to weaken further or whether we are perceived to be reducing short-term rates by "too little too late"--that is, "falling behind the curve". That the interest rate response was primarily to the prospects for a stronger economy, rather than a more restrictive policy path

is suggested by the rise in stock prices, which does not seem to indicate expectations of cumulating weakness in the economy owing to an excessively tight monetary policy. In addition, the backup in bond yields and the reduction of the spread between the funds rate and the 30-year bond rate is at least consistent with expectations that the economy will continue to expand at a fairly good pace, though perhaps also with little underlying progress on inflation.

During the 1980's, one characteristic of a stabilizing monetary policy has been a tendency for interest rates and money supply growth rates to move generally in opposite directions. This pattern, which suggests that countercyclical interest rate movements rather than changes in spending are dominating money demand, also has prevailed recently. Money supply growth strengthened appreciably over the spring and summer as rates dropped.

In July, the aggregates grew rapidly--considerably more so than expected--and robust growth for M2 has extended into August. The strength of money growth likely reflects a number of factors, including a larger drop in market interest rates than had been built into the path at the last FOMC meeting. In addition, it may be that the restocking of tax-depleted balances happened faster than the staff had allowed for. More generally, the unusual shortfall in money growth earlier this year seems to be in the process of being recouped. Noncompetitive tenders at Treasury auctions have

fallen off even faster than might have been expected based on interest-rate relations, offsetting some of the overage from the first quarter of the year. Even after taking account of the interest rate and catch-up effects, however, money growth in recent months still looks fairly strong, consistent with at least moderate expansion of nominal income.

In the next few months, the implications of money supply information may be even more difficult to divine. In the bluebook, we have projected a slowing in the aggregates, based in part on underlying developments in financial markets, but also on the effects of the process of resolving the problems of thrift institutions.

The underlying picture is one of continued strength in M2 relative to income, owing to the effects of previous declines in market rates. But these effects will taper off if rates are stable for a time. In addition, the rebuilding of tax-depleted balances may be largely completed. Thus, even with nominal income running close to the pace of the first half of the year, some slowing in money growth might be expected over coming months absent an additional policy easing.

The effects of FIRREA and the actions of the RTC under it are likely to have a further damping effect on money growth, though of uncertain dimensions. The passage of the legislation, new insurance stickers and all, might

help to restore some confidence in thrifts, and the better performance of thrift deposits and runoff of noncompetitive tenders in recent months may already be evidence of an anticipatory effect as final legislation of some sort became more certain. But RTC will be supplying funds to thrifts and their depositors on an accelerated basis. A portion of the \$20 billion scheduled to be spent in coming weeks will replace M2 deposits in receiving institutions. Since a major objective is to reduce offering rates on deposits, it seems reasonable to expect that some of those repaid deposits will be recycled by their holders into instruments outside M2. In the bluebook, we have assumed that somewhat more than half the \$20 billion replaces M2 deposits, and that half of that leaves the aggregate.

M3 will be even more affected, since the rest of the \$20 billion will be repaying managed liabilities, some of which are in M3. In addition, thrift assets will likely fall further, reducing funding needs. Two wild cards are the attitudes, first, of the holders of brokered deposits as they see their deposits being repaid early, and, second, of the Home Loan Banks. A tendency for brokered deposits to runoff clearly would damp M2 and even M3. On the other hand, if early signals of a much tighter advances policy by Home Loan Banks prove out, more of the RTC's \$20 billion could be spent replacing this source of funds, rather than elements in M2 or M3.

We expect any effects on money growth rates to taper off after the initial spending push. Over time, the level of M2 will be reduced if there is a permanent downward adjustment in offering rates relative to market rates, that more than offsets any return of confidence. The level of M3 will be held down by the rise in intermediation costs associated with higher insurance rates, capital requirements and investment restrictions, as well as by the movement of assets off of depository balance sheets as institutions are resolved.

But any restraint on money growth as a consequence of FIRREA and RTC policies is expected to affect the level of velocity, and not to indicate a current or prospective shortfall in the economy. Working out the thrift situation and recapitalizing these institutions may have a pronounced effect on the patterns of financial flows, but is much less likely to affect the overall level of interest rates or economic activity. To be sure, we have already seen upward pressures on interest rates on certain instruments with considerably greater supplies coming onto markets, such as Treasury bills and mortgages and related securities. Other rates may tend to adjust downward, however, including those on deposits and their close substitutes and on the assets purchased by intermediaries benefitting from the reduced competition from thrifts. The supply and rate adjustments propelled by this process will induce portfolio shifts among

savers out of monetary assets and into market instruments, held directly or indirectly.

The size of the rate adjustments and portfolio shifts will depend on the strategies chosen by the government and the thrifts to comply with the legislation, and the responsiveness of savers to changing yield relationships. And the process may involve a major restructuring of financial flows, especially in the mortgage market, with possible effects, both plus and minus, on specific sectors of the economy. It is less likely to be accompanied by an independent credit rationing or availability effect, such as those that formerly added to the restraint imposed by higher interest rates in disintermediation episodes prior to deposit rate decontrol. The development of a much wider array of financing vehicles for both borrowers and lenders--and in particular the capacity of the capital markets to securitize and sell vast quantities of mortgages--may well allow the overall level of economic activity to escape being significantly affected by the rechannelling of savings flows.

In the staff forecast, as Mike has noted, essentially unchanged short-term interest rates in the period ahead are seen as consistent with maintaining the economy along a track of moderate growth, but with no decline in the underlying inflation trend. Thus alternative B might be considered if the risks around this outlook were thought to

be fairly well balanced and the results acceptable. The steady funds rate under that alternative might provoke some further backup in rates as remaining expectations of policy easing were frustrated and rethought, but the rise probably would be small, and without much impact on the economy.

If the thrift situation were seen as possibly having a significant negative impact on the economy, alternative A, or a predilection toward ease might seem more reasonable. A leaning in this direction might also be seen as needed to keep short-term real interest rates from rising and restraining activity further should the better price data expected for the second half of the year cause inflation expectations to be revised down. Damping any rise in real short-term rates might be considered particularly important if there were doubts that the dollar will decline as projected. As Ted has already noted, a steady dollar would contribute to improved price performance, but also would tend to hold down economic expansion relative to our staff forecast, especially in the second half of 1990.

But, real interest rates, especially long-term rates, probably are already lower than they were a few months ago. Although the economy has slowed from the unsustainable pace of 1987 and 1988, growth has not been running much, if any, below potential rates of expansion. If the lower real rates of this spring were seen as increasing the odds on a substantial rebound in activity, or if the staff

inflation outlook were credible but not acceptable, consideration might be given to the possibility of a tightening of policy in coming weeks, as under alternative C or a variant thereof.

Finally, with regard to implementation issues, the staff has retained the lower expected changes in borrowing we used the last time to accompany the different federal funds rates of the various alternatives. This reflects the dominance of seasonal borrowing, which is less interest sensitive than adjustment borrowing. But seasonal credit does respond to some degree to changes in the spread between the federal funds and discount rates. This can be seen in its behavior this month, in which, counter to its usual seasonal pattern, such borrowing has declined as spreads narrowed. As a consequence of the remaining elasticity, the staff believes that alternative A can be implemented through about a \$100 million decrease in the borrowing objective, and, as a technical matter, would not require a cut in the discount rate.